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THE LATIN AMERICAN DEBT
(THE MEXICAN MODEL)

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FEBRUARY 16, 1990

Report Documentation Page

Form Approved
OMB No. 0704-0188

1. REPORT DATE **16 FEB 1990**	2. REPORT TYPE	3. DATES COVERED **-**
4. TITLE AND SUBTITLE **The latin American Debt (The Mexican Model)**		5a. CONTRACT NUMBER 5b. GRANT NUMBER 5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S)		5d. PROJECT NUMBER 5e. TASK NUMBER 5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) **National War College,300 5th Avenue,Fort Lesley J McNair,Washington,DC,20319-6000**		8. PERFORMING ORGANIZATION REPORT NUMBER
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)		10. SPONSOR/MONITOR'S ACRONYM(S) 11. SPONSOR/MONITOR'S REPORT NUMBER(S)
12. DISTRIBUTION/AVAILABILITY STATEMENT **Approved for public release; distribution unlimited**		
13. SUPPLEMENTARY NOTES		
14. ABSTRACT **see report**		
15. SUBJECT TERMS		

16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT **unclassified**	b. ABSTRACT **unclassified**	c. THIS PAGE **unclassified**		**11**	

On Friday, August 13, 1982, the Mexican finance minister arrived in Washington with only one day's advance notice. His country was on the brink of bankruptcy and he needed U.S. financial assistance. Unless the finance minister could piece together a financial rescue package in Washington to avoid default on the country's $107 billion external debt, Mexico would be forced to undertake the largest suspension of payments to foreign creditors, particularly to U.S. private banks, by any government in the post-World War II period. It was widely believed that such an event could seriously disrupt the entire international financial system.

The Mexican debt bomb exploded on a largely unsuspecting international financial community. The subsequent psychological shock, combined with the size of Mexico's foreign debt and the dangerous levels of U.S. commercial bank exposure in Mexico, was enough to convince most observers that Mexico's payment problem was unique. Unfortunately, as other large Latin American debtors (Brazil, Venezuela, Argentina) followed Mexico into payment difficulties, the Mexican crisis was looked upon as the beginning of a serious new threat to international financial stability that quickly became known as the Third World debt crisis.

Mexico ranks as the Latin American country that is most important to the United States for reasons of geography, politics, and economics. Although relations between the two nations have been strained from time to time ever since the United States had annexed almost 40 percent of Mexico's territory a century earlier, strong links bind the two countries together. Mexico and the United States share a 1,760-mile border, and millions of legal and

illegal immigrants flow annually into the United States. Severe economic turmoil in Mexico would only aggravate this explosive problem.

The purpose of this paper is (using Mexico as a case study) to take a superficial look at the Latin American foreign debt, U.S. Government efforts to solve this burgeoning problem, and its possible effects on U.S. National Security in Latin America.

ROOTS OF MEXICO'S FINANCIAL CRISIS

"The Mexican Time Bomb" by Norman Bailey and Richard Cohen describes Mexico's crisis as having evolved over time and in much the same way such crises evolved in other developing nations. Mexico's economy, like that of many other Latin American countries, was riddled with profound structural problems created by a fast-growing population and a rapid transition from a rural to an urban based economy with wide disparities in class and regional income.

From 1940 to 1970, the Mexican economy grew at an average annual rate of 6 percent. In addition, during the 1950s and 1960s Mexico coupled economic growth with an inflation rate that averaged less than 5 percent, while many of Latin America's other large economies were suffering intermittent hyperinflation.

But thirty years of exemplary growth accompanied by a low rate of inflation masked enormous structural stresses--stresses that were aggravated by the distribution of Mexico's post-World War II wealth and the means by which this new wealth was created.

Mexico's economy had been traditionally marked by wide disparities in income according to socio-economic class and geographic area. These wide income differentials, typical of poverty-ridden Latin American countries, were exacerbated by the postwar concentration of new industry in the country's already more prosperous central and northern urban centers and by the sustained depressed wage levels of the country's work force (both rural and urban) during this period. In a 1980 report, the World Bank identified Mexico as having one of the worst profiles of income distribution of any nation.

By the middle of the 1960s the rapid growth of Mexico's population, averaging 3.5 percent a year, was generating a second structural problem...chronic unemployment and underemployment. Mexico's postwar development strategy served to exacerbate the problem. By concentrating on rapid industrialization and capital-intensive job creation, the economy increasingly lagged in providing enough jobs for the staggering number of new entrants into the labor market each year. At the same time, efforts at rapid industrialization encouraged a huge rural migration to Mexico's largest cities; Mexico City, Guadalajara, and Monterrey, the major centers of industrial concentration, soon became over-populated with the unemployed and the underemployed. The potential political threat to Mexico's stability posed by these growing structural problems began to attract the attention of the nation's policymakers. Nevertheless, Mexico's governing elite failed to give priority to them until the political order exploded in 1968 with student-led demonstrations.

In response, Mexico, like many other developing Latin nations, began expensive development programs aimed at reducing economic and demographic stress. These programs required very large capital investment, which to a great extent determined Mexico's economic policy in the 1970s. The economies of the developing countries were constructed to take advantage of the prevailing global inflation. Cheap foreign sources of capital carrying low to negative real interest rates in the advanced industrial countries (especially the United States) encouraged foreign borrowing, while rising commodity prices encouraged rapid exploitation and export of commodities, such as petroleum, along with the belief that a large foreign debt could be efficiently serviced into the indefinite future. Growing export revenues and inexpensive foreign money made expensive development programs appear financially sound.

Obsessed with its sovereignty in light of its economic weakness, especially in the United States, Mexico found debt a politically preferable option to direct equity investment. For much the same reason, the other major countries of Latin America took the same route.

Thus, the increased borrowing by Mexico and her sister countries using inexpensive foreign loans as the vehicle for economic development, and the eager advancing of credit by commercial banks with almost no regard to the risks involved (believing that countries never go bankrupt), eventually brought about the 1982 crisis.

SOLVING THE CRISIS

George Bush, like his predecessor Ronald Reagan, has been searching for new ideas to solve the Third World debt. The Reagan administration put its hopes in the Baker Plan. George Bush is hoping that the Brady Plan will bring some measurable success.

The Baker Plan

In 1985, then Secretary of Treasury James Baker announced the Baker Plan. Underlying this Plan were two tough-minded principles: Taxpayer institutions such as the World Bank and International Monetary Fund would not assume added risk, and U.S. citizens shouldn't have to bail out the New York banks. But at the same time, the plan strongly encouraged the banks to protect their sovereignty by collecting the full amount owed by the debtor countries.

The Baker Plan assumed that new loans by commercial banks, coupled with austere reform programs in the debtor countrins, would spur new economic growth and generate capital for payment of foreign debt.

The Baker Plan succeeded in reducing the risks to commercial banks. It failed to create new economic growth, however. The discontent of Latin citizens was registered most dramatically in February 1989, when Venezuelans rioted in Caracas and other major cities in protest against austerity measures prompted by Venezuela's debt crisis. In the course of a few days an estimated 300 people died.

The Brady Plan

On March 10, 1989, Treasury Secretary Nicholas Brady announced the Bush Administration's new policy on Third World indebtedness. The plan called on U.S. commercial banks to accept an orderly process of debt reduction, and called on the international financial institutions, the IMF and World Bank, to support this process through changes in their lending policies. To qualify for debt reduction, the plan stipulates that debtor countries should be undertaking sound economic policies aimed at encouraging domestic savings, foreign investment and promoting the return of flight capital.

According to Jeffrey Sachs' "Making the Brady Plan Work," the general mechanism for achieving debt reduction called for by Secretary Brady is for creditor banks to agree voluntarily to reduce the value of their claims (either through a cut in principal or interest) in return for guarantees on the remaining portions of the debt.

To encourage the banks to accept debt reduction rather than hold their debt, the IMF and World Bank are called upon to help finance the guarantees, either by providing collateral on the reduced value of the debt or by giving debtor governments financial support to repurchase their debt directly for cash. These international institutions agreed to provide up to $25 billion over three years, and Japan committed to an additional $4.5 billion.

On February 5, 1990, Mexico and representatives of its 450 foreign commercial creditor banks signed a debt-reduction agreement that U.S. and

Mexican officials said would spur economic growth in Mexico and serve as a model for other developing nations. The accord is the first in which commercial creditors have agreed to reduce the debt of a Third World country. U.S. officials describe the agreement as a milestone for the Brady Plan.Only time will tell what effect, if any, the Brady Plan will have on the Latin American debt problem.

U.S. NATIONAL SECURITY

One of the objectives considered important to U.S. interests worldwide but especially within the Latin and Caribbean countries, is the stabilization of democratically elected governments. Without an easing of the debt burden, the Bush Administration fears the U.S. risks toppling fragile Latin democracies...which have chalked up little or no economic growth since 1982...and sparking takeovers by the radical left or the military right. At the same time, a growing number of economists think a reduction in the Latin debt is vital to continued U.S. growth. By some estimates, U.S. business has lost over $75 billion in exports since the debt crisis erupted eight years ago and began forcing Latin nations to devote even more of their foreign exchange earnings to servicing loans.

In an eerie way, political change seems to be following the economic trends, with an appropriate time lag. During the early 1980s there was a remarkable flowering of democracy. For a time Latin America enjoyed the best political leadership, taken as a whole, than it has had in this century...more responsible, more firmly in the democratic mold, more respectful of human rights, and more prepared to take the economic measures necessary for modernizing its economies.

The decade of the 1990s, most Latins think, will be quite different. Dissatisfaction with the performance of the economy has produced a new revolution. In early 1989 for instance, a nationalist right-wing party appeared set to win pending elections in Argentina; in Brazil two anti-American leftist parties have rebounded; and in the Mexican presidential elections last year, the opposition held Mr. Salinis' party, the Partido Revolucionario Institucional (PRI) to the smallest margin of victory in 50 years. The United States must take care to balance its hegemonic economic influence with the ability of the Latin governments to meet the requirements of loan payments.

To the extent that debtor countries respond to the demands of the banks and U.S. officials, they are obliged to disregard popular demands and dissatisfaction over ever-decreasing standards of living. The violent demonstrations in Venezuela testifies to the fact that the citizens of debt-ridden Latin countries are unwilling to endure what appears to be a lifetime of personal sacrifice in order to service their respective national foreign debts.

U.S. government officials must be concerned about the problem of illegal immigrants who would rush to our borders to escape the violence and chaos that would result from the collapse of the economy of a debtor country. Mexico would definitely pose a serious problem. Should a breakdown occur in Mexico, millions of Mexicans would cross into the United States to avoid the violence and seek a livelihood. The prelude to such a movement is already underway. Approximately 2 million illegal entrants were taken into U.S.

custody at the southern border in 1988, about a half million more than in 1987. Large numbers of Mexicans--perhaps four times as many as those apprehended--enter the United States every year. Neither the U.S. economy nor the American taxpayer is prepared to absorb this kind of population increase.

CONCLUSION

Although the Brady Plan changed the direction of U.S. policies on Third World indebtedness, the question still remains...will it work?

The signing of a debt reduction agreement with Mexico is a political triumph for both Mexico and the United States. Some experts argue that, in purely economic terms, it earns a more restrained judgment. It will bring real benefit to Mexico but it is far from a grand sweeping solution to Mexico's financial troubles. As in most of the debtor countries, a grand sweeping solution requires a reorganization of the internal economy. There Mexico is doing an extaordinarily impressive job.

The agreement will indeed reduce Mexico's debt to the banks. But only because Mexico is apparently willing to reform its own economic life...By opening its markets to world competition, cutting subsidies, selling off inefficient enterprises, pushing budget toward balance. Mexico has done far more to help itself than any other of the debtor countries.

A number of State Department officials are of the opinion that the Brady Plan and/or some variation of it will provide some debt reduction and a measurable amount of immediate economic relief to some Latin countries. The

creation of new jobs and a noticeable reversal of capital flight will also help to defuse the potentially explosive political time bombs created by economic instability. However, except for the complete "forgiveness" of debt by creditor banks, most Latin countries will retain a burdensome foreign debt. Even the drafting officers of the Brady Plan implicity recognized that many debtor countries would be unable to repay their commercial bank debts in full even if repayment is stretched out over time.